No.

In the Supreme Court of the United States

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In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 1305

LORIN A. CRANSON, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The District Court rendered no opinion, and its findings (R. 60), incorporating the stipulated facts (R. 27–38), and conclusions of law (R. 61), are not reported. The opinion of the Circuit Court of Appeals (R. 71–74) is reported at 146 F. 2d 871.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on January 24, 1945 (R. 75). A

petition for rehearing, filed by the taxpayer on February 20, 1945, was denied on February 26, 1945 (R. 76). The petition for a writ of certiorari was filed on May 23, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether a cash distribution, received by the taxpayer during 1936, was paid out of the distributing corporation's earnings or profits and is consequently taxable as a dividend under Sections 22 (a) and 115 (a) of the Revenue Act of 1936.

The answer to this question depends on whether the corporation's earnings or profits were reduced either by a loss realized by the corporation upon the liquidation of three subsidiaries in 1936, or by the operating deficits of the subsidiaries existing at the date of the liquidation.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are printed in the Appendix, *infra*, pp. 17–26.

STATEMENT

The District Court found the facts as stipulated (R. 60). The material portions of the stipulation of facts (R. 27–59) may be summarized as follows:

Prior to August 31, 1936, Honolulu Oil Cor-

poration, Ltd. (hereinafter referred to as "Honolulu") owned all of the issued and outstanding stock of three subsidiary corporations, formed primarily for the purpose of acquiring and developing prospective oil properties and patents relating to the processing of crude petroleum (R. 31–33). On August 31, 1936, the three subsidiaries liquidated and distributed to their sole stockholder, Honolulu, all their assets, subject to liabilities, in complete cancellation and redemption of all their stock. The subsidiaries then dissolved. Honolulu realized a loss upon the liquidation of the subsidiaries of $1,225,908.63, which amount was charged off on its books as a loss. No part of the loss was recognized as a deductible loss for income tax purposes under Section 112 (b) (6) of the Revenue Act of 1936, and no part of the loss was deducted by Honolulu in its 1936 return. (R. 33.) The loss of $1,225,908.63 is the result of deducting from $1,690,623.26, which is the total of the investments in the subsidiaries' stock and the unrepaid cash advances to the three subsidiaries by Honolulu, the amount of $464,-714.63, representing the actual cost, and also the value, of the assets, minus liabilities, of the three subsidiaries which Honolulu received (R. 34–35, 59).

The assets so received by Honolulu were entered on its books at the cost to the subsidiaries and these cost figures were used thereafter by Honolulu in computing depreciation, depletion,

and gain or loss on sale for purposes of determining its earnings or profits available for dividends after August 31, 1936 (R. 35).

The three subsidiaries sustained operating losses during the period from their incorporation to their dissolution, and the amount of their operating deficits on August 31, 1936, totaled $1,205,451.61. During the years 1928–1933, inclusive, Honolulu filed consolidated income tax returns and the operating losses of the subsidiaries for those years, totaling $769,103.67, were applied, for income tax purposes, in reduction of the net income of Honolulu (R. 36–37). But since Honolulu itself had an operating loss in 1933, the losses of the subsidiaries availed of in the consolidated returns amounted to $694,151.15 (R. 37–38).

On January 1, 1936, Honolulu had available for dividends earnings or profits accumulated after February 28, 1913, in the amount of $139,631.26. Honolulu's earnings or profits during the year 1936 amounted to $931,553.82, before deducting any portion of the loss realized upon liquidation of the subsidiaries on August 31, 1936, in the amount of $1,225,908.63, or before deducting the aggregate operating deficits of the subsidiaries in the amount of $1,205,451.61 (R. 38).

During 1936, Honolulu had outstanding 937,743 shares of stock, on which it paid four cash distributions of 25 cents per share during that year (R. 38). The distributions which taxpayer re-

ceived from Honolulu on shares of stock owned by him were in the total amount of $450 (R. 28–29).

On his income tax return for 1936, taxpayer reported the amount of $450 as taxable dividends (R. 28–29). Subsequently, he filed timely amended claims for refund of the tax paid by him for 1936. In these claims, disregarding items not here material, he asserted an overpayment of $51.84, based on the ground that only $18 of the $450 distribution, received during 1936, represented a taxable dividend, and that the remainder of $432 was not a taxable dividend because not paid out of earnings or profits accumulated by the corporation after February 28, 1913, or out of earnings or profits for the taxable year. The Commissioner rejected these claims and this suit was instituted to recover the amount of $51.84, plus interest thereon. (R. 2–11, 16–19, 20–23, 29–31, 56, 57–58.)

The District Court concluded that neither the loss sustained by Honolulu upon liquidation of its subsidiaries nor the operating deficits of the subsidiaries on the date of liquidation diminished the amount of Honolulu's earnings or profits which were otherwise available for distribution as dividends during 1936; hence, it approved the Commissioner's disallowance of the claim for refund (R. 60–61). The Circuit Court of Appeals affirmed (R. 71–74).

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ARGUMENT

Section 22 (a) of the Revenue Act of 1936 (Appendix, *infra*, p. 17) includes dividends within the definition of taxable gross income. Section 115 (a) (Appendix, *infra*, p. 20) defines a dividend as any distribution by a corporation to stockholders out of earnings or profits accumulated after February 28, 1913, or out of earnings or profits of the taxable year computed as of the close of the year, and Section 115 (b) (Appendix, *infra*, p. 20) provides that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits.

There is no question that Honolulu had sufficient earnings or profits [1] to cover the total cash distribution of $937,743 made by it during 1936, and hence that the distributions are taxable dividends in their entirety, unless its earnings or profits were reduced by the loss realized by it upon liquidation of its subsidiaries in 1936, or by the operating deficits of the subsidiaries existing at the time of the liquidation.

1. *The loss on liquidation of the subsidiaries did not reduce Honolulu's earnings or profits.*—The taxpayer's contention (Br. 53–57) that the

[1] Its earnings of $931,553.82 for 1936 alone, and $139,631.26 accumulated at the beginning of that year, total $1,071,185.08 (R. 38).

earnings and profits of Honolulu must be reduced by the loss of $1,225,908.63 which it realized on the liquidation of the subsidiaries,[2] although such loss was not recognized for tax purposes, is in direct violation of Article 115–3 of Treasury Regulations 94 (Appendix, *infra*, p. 23) applicable to the year 1936, which provides in part that—

> Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.

This Court has only recently approved an identical Regulation, promulgated under the Revenue Act of 1938,[3] as "reasonable and a valid exercise of the rule-making power." *Commissioner* v. *Wheeler*, No. 354, decided March 26, 1945.

The Regulation makes no exceptions and, applied here, directs without equivocation that Honolulu's loss on the liquidation in 1936 should not reduce its earnings or profits, for tax purposes, in any amount, since the loss was not recognized

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[2] This contention is presented as an alternative argument by taxpayer but is considered first here, since the taxpayer's principal contention, that the operating deficits of the subsidiaries reduced Honolulu's earnings, involves in part a discussion of the loss on liquidation. See *infra*, p. 14.

[3] Article 115–3 of Treasury Regulations 101. The Regulation originated in Article 115–1 of Treasury Regulations 86, promulgated under the Revenue Act of 1934.

to any extent in that year. Section 112 (b) (6) of the Revenue Act of 1936 (Appendix, *infra*, pp. 17–20).

Taxpayer does not discuss the Regulation but pitches his argument (Br. 53–57) on the unconstitutionality of Section 501 of the Second Revenue Act of 1940 (Appendix, *infra*, pp. 21–23) which incorporated the substance of the Regulation into the Internal Revenue Code and also amended all prior Revenue Acts to include the provision. But, as in the *Wheeler* case, it is unnecessary here to consider whether Section 501 violates the Fifth Amendment to the Constitution, because of its so-called retroactive features, since there was a valid controlling Regulation in effect when the liquidation occurred. Likewise, it is also unnecessary to consider the argument that Section 501 violates the Sixteenth Amendment to the Constitution, in that the taxpayer is required to pay a tax on capital. If the unconstitutional argument is intended to apply to the Regulation as well (although taxpayer's brief does not so state), then it is sufficient that this Court has approved the Regulation as resulting in a reasonable determination of earnings or profits for tax purposes.[4] In any event, it does not appear

[4] As pointed out by this Court in *Commissioner* v. *Wheeler*, *supra*, although the term "earnings or profits" has long been in the tax statutes, there has been no attempt to define its meaning by Congress until Section 501 of the Second Revenue Act of 1940 adopted the Regulation, first promulgated under the Revenue Act of 1934; this Court noted that the term

that taxation of the distribution in the taxpayer's hands would amount to an unconstitutional taxation of capital, since, regardless of the source of the distribution, his capital investment (his proportionate interest in the corporation, represented by his stock) remained the same after the distribution. Cf. 1 Mertens, *Law of Federal Income Taxation,* Sec. 9.29, p. 461. The taxpayer cannot, of course, show that this distribution to him will inevitably operate to prevent his ever regaining his total investment. His only constitutional interest is to prevent a tax on a return of his capital to him, and if he cannot show that, as a result of this distribution, he will not recover his capital, he has no ground for complaint. See Paul, *Selected Studies in Federal Taxation* (Second Series) pp. 151–152. Furthermore, since no one of the refund claims filed by the taxpayer (R. 12–23) alleges that Section 501 of the Second Revenue Act of 1940 or Article 115–3 of Treasury Regulations 94 (Appendix, *infra,* pp. 21–23) is unconstitutional, that question is not open to the taxpayer in a suit on the claims. *Real Estate-Land Title & Trust Co.* v. *United States,* 309 U. S. 13. And it should be noted that the argument that taxation of the distribution is a violation of the

"earnings or profits", in the tax sense, may not correspond exactly to taxable income, but it does not necessarily follow corporate accounting concepts either.

Sixteenth Amendment was first made in the petition for rehearing in the court below (Br. 53).[5]

2. *The operating deficits of the subsidiaries did not reduce Honolulu's earnings or profits.*—The taxpayer contends primarily (Br. 17–52) that the principle of *Commissioner* v. *Sansome,* 60 F. 2d 931 (C. C. A. 2d), certiorari denied, 287 U. S. 667, applies to permit reduction of Honolulu's earnings or profits by the operating deficits of the subsidiaries. The rule of the *Sansome* case is that where a new corporation acquires all the assets of a predecessor corporation in a tax-free reorganization, the accumulated earnings or profits of the predecessor pass intact to the new corporation as earnings, and remain available for distribution as dividends by the new corporation. In a nontaxable liquidation of a subsidiary corporation also, the earnings or profits of the subsidiary are "inherited" by the parent as earnings and are available for payment of dividends by it. Article 115–11 of Treasury Regulations 101 (Appendix, *infra,* pp. 25–26); *Robinette* v. *Commissioner,* 148 F. 2d 513 (C. C. A. 9th).

[5] On consolidated returns in years prior to 1936, Honolulu reduced its income by the operating losses of the subsidiaries in the amount of $694,151.15 (R. 37–38). Having had the benefit of deducting this amount once, it may not again deduct those losses directly or indirectly. Consequently, the amount of Honolulu's deductible loss, in whatever year it may be recognized, will be no more than $531,755.48 ($1,225,908.63 minus $694,151.15). *Ilfeld Co.* v. *Hernandez,* 292 U. S. 62; *McLaughlin* v. *Lumber Co.,* 293 U. S. 351.

Although this rule is firmly established in cases where the liquidated corporation had accumulated earnings or profits,[6] it has never been applied, as taxpayer concedes, in any case where the liquidated corporation had an operating deficit in lieu of earnings or profits. Furthermore, Section 115 (h) of the Revenue Act of 1938 (Appendix, *infra*, p. 21), the Regulations incorporating the *Sansome* principle (see Article 115–11 of Treasury Regulations 94 and 101 (Ap-

[6] See *United States* v. *Kauffmann*, 62 F. 2d 1045 (C. C. A. 9th); *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641 (C. C. A. 5th); *Fain* v. *Commissioner*, 76 F. 2d 1008 (C. C. A. 5th), certiorari denied, 296 U. S. 588; *Harter* v. *Helvering*, 79 F. 2d 12 (C. C. A. 2d); *Baker* v. *Commissioner*, 80 F. 2d 813 (C. C. A. 2d); *Corrigan* v. *Commissioner*, 103 F. 2d 1010 (C. C. A. 3d), certiorari denied, 308 U. S. 576; *Georday Enterprises* v. *Commissioner*, 126 F. 2d 384 (C. C. A. 4th); *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (C. C. A. 6th); *Putnam* v. *United States* (C. C. A. 1st), decided May 25, 1945; *Barnes* v. *United States*, 22 F. Supp. 282 (E. D. Pa.); *Crocker* v. *Commissioner*, 29 B. T. A. 773; *Estate of McClintic* v. *Commissioner*, 47 B. T. A. 188.

Campbell v. *United States*, 144 F. 2d 177 (C. C. A. 3d), is an exception but the decision turned on the peculiar facts there involved.

Congress first incorporated the principle completely in Section 115 (h) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and has indicated its approval of the rule in connection with the 1938 and other Revenue Acts. S. Rep. No. 2156, 74th Cong., 2nd Sess., p. 19 (1939–1 Cum. Bull. (Part 2) 678, 690), relating to Section 115 (h) of the Revenue Act of 1936; S. Rep. No. 1567, 75th Cong., 3d Sess., pp. 18–19 (1939–1 Cum. Bull. (Part 2) 779, 792), relating to Section 115 (h) of the Revenue Act of 1938; H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 41, 42 (1940–2 Cum. Bull. 496, 526–527); and S.

pendix, *infra,* pp. 23–26), and the Congressional Committee reports approving the rule (footnote 6, *supra*) refer only to "earnings or profits" and do not indicate that the rule is to be extended to operating deficits which are the very antithesis of "earnings or profits." [7] The *Sansome* case was decided fifteen years ago, and the absence of any authority [8] that the rule applies to operating deficits is significant.

Rep. No. 2114, 76th Cong., 3d Sess. (Part 1), p. 25 (1940-2 Cum. Bull. 528, 545–548), relating to Section 501 of the Second Revenue Act of 1940.

[7] The taxpayer suggests that both the Regulations (Br. 29–31) and S. Rep. No. 2114, 76th Cong., 3d Sess. (Part 1) p. 25 (1940-2 Cum. Bull. 528, 545–548) (Br. 45–46), use the term "earnings or profits" as referring to the earned surplus account and hence as embracing a negative balance (a deficit) in the account as well as a positive balance, or earnings. We find nothing to support this suggestion. Both the Senate Report and the Regulation relate to the amount of earnings or profits available for dividends in the tax sense and are in no way concerned with the accounting aspect of the question. Furthermore, it seems obvious that if the earned surplus account were meant, that term would have been used.

[8] In *Senior Investment Corp.* v. *Commissioner*, 2 T. C. 124, pending on review (C. C. A. 6th), one question was whether the corporation had a deficit in accumulated earnings or profits at the beginning of the tax year, so that it was entitled to a deficit credit against income for purposes of computing its surtax on undistributed profits under Section 26 (c) (3) of the Revenue Act of 1936, as amended by Section 501 (a) (2) of the Revenue Act of 1942. Prior to the tax year it had transferred some of its assets to another company in a reorganization at a time when, as it contended, it had a deficit. Both parties were in agreement that, if it had a deficit, the deficit was divisible between the two corporations, and the only issue was as to the method of division. Hence,

Moreover, there is a sound reason for applying the *Sansome* rule to earnings or profits and not to operating deficits. When a corporation acquires the assets of the liquidating corporation having accumulated earnings, it in fact receives assets which include the earnings. But where a corporation acquires the assets of a liquidating corporation having a deficit, the assets received may be less than they otherwise would have been if the deficit had not been incurred, but the assets actually transferred in liquidation are not reduced or affected in any way by the previously incurred deficits. Thus the acquiring corporation does not take over or inherit a deficit along with the assets.

Furthermore, the *Sansome* rule operates to prevent escape from taxation of the old corporation's earnings; without such a rule, earnings or profits which would be taxable as dividends if distributed by the old corporation could be transferred in a non-taxable transaction to another corporation and subsequently be distributed by it as a non-taxable distribution of capital. See *Putnam* v. *United States, supra; Murchison's Estate* v. *Commissioner, supra;* dissenting opinion of Judge Jones in *Campbell* v. *United States, supra.* Where the

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the Tax Court did not decide whether a deficit passes to a transferee corporation in a reorganization. The case presented a different question than does the instant one and was concerned only with the amount of the deficit retained by the transferor.

old corporation has a deficit, however, no such considerations arise. Rather the avoidance lies the other way; application of the rule to deficits would result in exempting Honolulu's earnings or profits from taxation as dividends upon their distribution.

The contention (Br. 35–46) that the operating deficits must reduce Honolulu's earnings or profits, in order to produce an equitable result and reflect the full loss sustained by Honolulu, proceeds on the accounting premise that a corporation's earnings or profits must be reduced, by one means or another, in the full amount of every loss it sustains, whether or not the loss is recognized and deductible for tax purposes. We submit that the premise is unfounded insofar as tax "earnings or profits" are concerned. The assumption that, if an unrecognized loss does not reduce earnings or profits directly, an indirect reduction must be made for the loss in the guise of subtracting the operating deficits which produce the loss,[9] is contrary to the expressed intent of Congress that earnings or profits shall be affected only as losses are recognized. Furthermore, although use of the transferors' bases for the assets

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[9] As a bookkeeping proposition Honolulu did not acquire the operating deficits of the subsidiaries. The assets accounts of the subsidiaries were entered as assets on Honolulu's books at cost to the subsidiaries (R. 35). While Honolulu charged off, as a loss, its investment in the subsidiaries previously carried as an asset (R. 33), the subsidiaries' deficits as such do not appear on its books (R. 35).

acquired may mean that Honolulu will not be able, in the future, to deduct its loss on its investment in the subsidiaries in full, it has no cause for complaint since deductions are matters of legislative grace. Moreover, even though the losses may not be fully reflected in the corporation's tax accounting, the taxpayer, as a stockholder, is in a different position. Any actual losses suffered by his corporation will be reflected in his tax accounting when he disposes of his stock.

Since Section 115 (a) (2) defines a dividend as a distribution from earnings of the taxable year, Honolulu would not have been able to reduce its earnings of $937,430 for 1936 by the amount of its own deficit, if it had had one, at the beginning of that year, in determining the earnings available for payment of dividends at the end of 1936. It seems, likewise, that it should not be permitted to diminish its 1936 earnings by the amount of the deficits of the subsidiaries incurred prior to 1936. If it be assumed *arguendo* that the operating deficits of the subsidiaries passed to Honolulu, we submit that only those deficits incurred by the subsidiaries in 1936 could apply against Honolulu's own 1936 earnings. Since the record fails to show these amounts, it follows that at least Honolulu's earnings of $937,430 for 1936 were available for the dividend paid to its stockholders in that year.

CONCLUSION

There is no conflict of decisions and the instant case was correctly decided in accordance with the controlling authorities. The petition for a writ of certiorari should, therefore, be denied.

Respectfully submitted.

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